Insight

Coronavirus and Business Interruption Insurance Coverage

THOMAS KINGSLEY | APRIL 14, 2020

Executive Summary

- In the wake of the economic disruption caused by coronavirus many businesses are looking to make insurance claims despite their policies specifically excluding losses due to pandemics.
- The president and senior lawmakers have suggested that insurers should pay these claims, fundamentally assaulting constitutional contract law and with the potential to topple the insurance industry.

Introduction

Both the coronavirus and national quarantine efforts to contain it have resulted in businesses shuttering across the United States. Many of these firms hold business interruption insurance coverage, and despite the fact that this insurance typically does not cover losses due to pandemics, some are suing to force their insurers to pay their claims. Policymakers are engaging in this fight, too: The president of the United States called for insurers to pay out to businesses in distress, and some legislators have gone even further, with multiple states proposing legislation that would retroactively expand coverage and require insurers to pay business interruption coverage claims, a development that undercuts the entirety of U.S. contract law.

Business Interruption Coverage

Business interruption coverage is not typically sold as a stand-alone insurance policy in the United States. Instead, it is sold as an add-on to existing property and casualty contracts. A business interruption policy will usually cover a wide range of business losses in the event of a business interruption event, including profits, fixed costs, wages, taxes, and loan payments. The larger the business, the more likely it is that is has purchased some kind of business interruption coverage, with only 33 percent of small businesses having some form of coverage.

As written into most insurance contracts, a business interruption event is usually defined as *physical* loss (perhaps destruction of merchandise) in response to a *physical* event (natural disasters or theft). Even alone, this definition would exclude lost revenue as a result of the coronavirus pandemic, which has not resulted in physical loss. Most business interruption contracts go further, however, by including “viral exclusion” clauses, specifically excluding from coverage losses due to widespread disease such as a pandemic, a lesson learned from the SARS epidemic.

SARS and Coronavirus

The 2002-2003 SARS outbreak led to millions of dollars paid by insurers in business interruption claims, including a claim of $16 million to one hotel chain, the Mandarin Oriental International. The fact that courts were prepared to construe widely – or ignore entirely – the requirements for “physical” damage led insurance companies nearly universally to implement the viral exclusion clause, and did significant injury to the conception that a business interruption event required physical damage. It is important to note, however, that these court challenges, even the successful ones, each represented individual cases rather than any broad reinterpretation of contract law. The strength of the requirement for physical damage was significantly weakened and made subject to legal challenge but not removed – insurers added the viral exclusion clause to make their position even more clear.

The coronavirus pandemic has breathed new life into this contentious issue. President Trump surprised many by addressing business interruption coverage in his daily coronavirus briefing on Friday, April 10. The president noted that he expected to see insurers pay business interruption claims except where the contract explicitly contains a viral exclusion clause, the much broader interpretation of business interruption policies. That same day (and it is unclear which preceded the other), seven Republican senators wrote to President Trump on behalf of insurers, pointing to the enormous legal and economic challenges of anything other than business interruption as defined in contract and agreed to by insurers and policyholders.

Seven states – New Jersey, Ohio, Massachusetts, New York, Louisiana, Pennsylvania, and South Carolina – have introduced bills requiring retroactive coverage of business interruption loans. Massachusetts, South Carolina, and New York have included in their draft bills language expressly targeting the viral exclusion clause, with the draft New York text noting:

Any clause or provision of a policy of insurance insuring against loss or damage to property, which includes, but is not limited to, the loss of use and occupancy and business interruption, which allows the insurer to deny coverage based on a virus, bacterium, or other microorganism that causes disease, illness, or physical distress or that is capable of causing disease illness, or physical distress **shall be null and void**. [emphasis added]

The Dangers of This Approach

The approach of these states poses several dangers to the U.S. economy.

Contract law and a stable investment environment

Proposed legislation retroactively and unilaterally altering existing contracts would appear to violate multiple provisions of the U.S. Constitution, most notably the Contracts Clause. Not only would this assault to the legal concept of a contract fundamentally destabilize financial services (and all other industries) but such hasty and ill-conceived lawmaking would make the U.S. fundamentally less attractive to investors in the future.

Protracted litigation

If passed, these bills would face significant legal challenge, and appropriately so, with the result that litigation could take years – years in which the business interruption claims would not be paid. The bills appear to be seeking to ensure that businesses receive financial assistance, but small businesses would not receive any funds, however appropriately, in anything like the time required to make a difference under the current circumstances. As the seven Republican senators and others have pointed out, there are more appropriate (and significantly faster) mechanisms for small business relief, most obviously the Payment Protection Plan provided for under the Coronavirus Aid, Relief, and Economic Security (or CARES) Act.

The presence of specific viral exclusion clauses, should give insurers the strongest possible legal case against claims, but there remains some room for court interpretation. Although viral exclusion clauses do often specifically include "viruses," the exclusion is often a subset of exclusions relating to "contaminants" and "pollutants," terms that will be inspected closely in courtroom arguments. Insurers faced a significant number of courtroom challenges in the wake of Hurricane Katrina in 2005 when courts were asked to decide whether damages were caused by "flooding" or "wind." Similarly, policyholders will contend, as they did in the SARS epidemic, that government-ordered closures constitute "physical damage," even where these conditions are covered by "civil authority" clauses. Caselaw from the SARS epidemic suggests that courts will favor policyholders to the extent possible.

The insurance business model

At a fundamental level, the insurance industry is not designed to address such widespread problems as the coronavirus. Insurance works by pooling risk. The fact that policies against fire damage are so universal, combined with the fact that incidences of fire damage are relatively rare, allows the insurance industry to provide fire insurance payouts to those who need it at the cost of a low premium to the entire population that pays for it. Here, neither of those factors are true. Pandemic insurance is not widespread, but more crucially the impacts of the coronavirus are not localized. It would not be possible to build an insurance industry that might have to pay claims to the entire country at a single point in time. If, however, epidemics or pandemics become more common, coverage will presumably increase and the price of premiums would decrease. At this point viral exclusion clauses would not be necessary and the public would have access to insurance policies priced appropriately for the risks that they cover. A remarkably similar conversation has emerged in the field of cyber insurance, asking whether business disruption as a result of cyberattacks should qualify as a covered business interruption.

Some contend that the insurance industry is not capable of responding to such widespread events, with the chair of the House Financial Services Committee, Maxine Waters, and others calling for a governmental pandemic risk insurance program much like the National Flood Insurance Program or the federal backstop created by the Terrorism Risk Insurance Act. This is clearly only the beginning of these conversations.

Economic stability

Were insurers to have to pay business interruption claims, it is likely that this would bankrupt the industry. David A Sampson, CEO of the American Property Casualty Insurance Association, estimates that a hypothetical 30 million claims from small businesses would result in losses of $220 – $383 billion per month, 10 times the amount in claims ever handled by the industry in a year. For the insurance industry to pay these claims would necessarily require insurers to liquidate their assets, a firesale that would likely precipitate a market crash. Toppling an industry at this time of economic instability would of course be ruinous and likely have a recessionary domino effect, either imperiling financial safety and soundness as a whole or drastically prolonging the necessary recovery time. Worse, requiring insurers to so deeply tap their reserves would render them incapable of responding to an emergency that they do explicitly cover, such as another natural disaster. This financial blow seems particularly unfair given that insurers do not price or risk their insurance policies to include pandemic risk – if they did, the cost of insurance premiums would be such that few would pay for them and we would lose insurance coverage completely.

Conclusions

If a business or market need exists, the insurance industry will consider the risk and provide an insurance policy priced to cover that risk. Insurance firm Lloyds of London, one of the world's first insurance markets, has insured a variety of unusual risks, from Keith Richard's hands, to Bruce Springsteen's voice, to Tom Jones' chest hair. Insurers are willing to offer pandemic insurance, too: despite the difficulties noted above, brokerage Marsh began providing pandemic business interruption insurance in 2018 (although it did not sell a single policy). One rare positive example is that of Wimbledon, the British tennis tournament, which cancelled rather than postponed its 2020 tournament, allowing it to collect a reported £250 million as a result of its pandemic insurance coverage. Constructing a policy to cover the risk of pandemics is not impossible, but it is simply not at this point financially feasible for the majority.

It is undoubtable that the coronavirus poses a significant and unique economic threat to U.S. and international businesses. Many will require extensive emergency financial assistance. Providing and facilitating this assistance is, however, the role of governments and regulators, not insurers. Construing contracts that specifically exclude pandemic coverage as allowing for coronavirus relief – or worse, enacting legislation that retroactively amends these contracts – is clearly unconstitutional. To to do so would endanger the safety and soundness of the financial system, disincentivize the entire insurance industry, and not even provide timely relief to companies that need it.